No. 516

In the Supreme Court of the United States

OCTOBER TERM, 1961

BORNE CHEMICAL COMPANY, INC., THOMAS E. BETNER, WILLIAM L. LESS, THOMAS A. MARINO, THE CEM SECURITIES CORPORATION, WALTER L. McMANUS, MARSHALL A. JACOBS, GEORGE E. ALLEN, CLYDE E. WILLIAMS, HENRY E. BRANDLI and H. CARL NORTHRUP,

Petitioners

v.

CHARLES A. McCLURE and RUTH H. McCLURE, suing on their own behalf and on behalf of all other stockholders of Borne Chemical Company, Inc., similarly situated,

Respondents

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR RESPONDENTS IN OPPOSITION

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INDEX

	Page
Opinions Below	1
Jurisdiction	1
Question Presented	2
Statutes and Rule Involved	2
Statement of the Case	5
Argument	12
I. The Decision Below Is Clearly Correct	18
II. The Decision Below Does Not Conflict With Any Decisions of This Court or With Any Other Circuit Court Decisions	24
III. Certiorari Should Be Denied	28
Conclusion	29

CITATIONS

Cases:

Acker v. Schulte, 74 F. Supp. 683 (S.D.N.Y. 1947)	28
Bankers Life and Casualty Co. v. Bellanca Corporation, 228 F. 2d 784 (7th Cir., 1961), *cert. denied* ——U. S.——(Oct. 9, 1961)	24-25
Board of County Commissioners v. United States, 308 U. S. 343 (1939)	27
Breswick & Co. v. Briggs, 136 F. Supp. 301 (S.D.N.Y. 1955)	27
Campbell v. City of Haverhill, 155 U. S. 610 (1895)	26, 27
Cohen v. Beneficial Industrial Loan Corp., 337 U. S. 541 (1949)	14, 17, 18, 19, 27
Cohen v. Beneficial Industrial Loan Corp., 170 F. 2d 44 (3rd Cir., 1948), *affirmed* 337 U. S. 541 (1949)	14

CITATIONS—*Continued*

Cases: Page

De Sylva v. Ballentine, 351 U. S. 570 (1956) 25, 26

Erie R.R. v. Tompkins, 304 U. S. 64 (1938) 18, 19

Fielding v. Allen, 181 F. 2d 163 (2d Cir., 1950), *cert. denied sub nom.* Ogden Corp. v. Fielding, 340 U. S. 817 (1950) 13, 14, 16, 21, 22, 27

Fischman v. Raytheon Manufacturing Co., 188 F. 2d 783 (2d Cir., 1951) 13, 14, 27

Fratt v. Robinson, 203 F. 2d 627 (9th Cir., 1953) .. 26

Gordon v. Loew's, Inc., 247 F. 2d 451 (3rd Cir., 1957) 26

Hooper v. Mountain States Securities Corporation, 282 F. 2d 195 (5th Cir., 1960), *cert. denied* 5 L. Ed. 2d 693 (1961) 26

Hoover v. Allen, 180 F. Supp. 263 (S.D.N.Y. 1960) .. 27

Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946) 17

Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947) 10

LeBoeuf v. Austrian, 240 F. 2d 546 (4th Cir., 1957) . 27

McManus v. The Jessup & Moore Paper Company et al., Civil Action No. 8015, E.D. Pa. (1949) ... 27-28

O'Sullivan v. Felix, 233 U. S. 318 (1914) 25, 28

Rothenberg v. H. Rothstein & Sons, 183 F. 2d 524 (3rd Cir., 1950) 19

Stella v. Kaiser, 81 F. Supp. 807 (S.D.N.Y. 1948) .. 27

Tobacco and Allied Stocks v. Transamerica Corp., 143 F. Supp. 323 (D. Del. 1956), *affirmed* 244 F. 2d 902 (3rd Cir., 1957) 26

CITATIONS—*Continued*

Statutes and Rule:	Page
Securities Exchange Act of 1934, as amended (15 U.S.C. §78a)	2, 22, 23
Section 9(e) (15 U.S.C. §78i)	23, 24
Section 10(b) (15 U.S.C. §78j)	2 et seq.
Section 16(b) (15 U.S.C. §78p)	23, 24
Section 18(a) (15 U.S.C. §78r)	23, 24
Section 23(a) (15 U.S.C. §78w)	3
Section 27 (15 U.S.C. §78aa)	5, 6, 19, 22, 23
Section 29(b) (15 U.S.C. 78cc(b))	2, 3, 4, 5, 12, 13, 14, 15, 17, 19, 20, 21, 23, 24
SEC Rule 10b-5 [Rule X-10B-5] (17 Code of Federal Regulations 240.10b-5)	2 et seq.
Securities Act of 1933, as amended (15 U.S.C. §77a)	23
Section 11(e) (15 U.S.C. §77(k)(e))	11, 24
28 U.S.C. §1254(1)	2
Copyright Act (17 U.S.C. §24)	26
Transportation Act of 1920	22
New Jersey Statute (14 N.J. Stat. Ann. §3-15)	5-20
Pennsylvania Statute (12 Purd. Pa. Stat. §1322)	5, 11, 18-19
Miscellaneous:	
3 Loss, Securities Regulation (2d ed. 1961)	27, 28
6 Moore's Federal Practice (1953)	28
Note, Security for Expenses Legislation—Summary, Analysis and Critique, 52 Col. L. Rev. 267 (1952)	28

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Opinions Below

The opinion of the Court of Appeals for the Third Circuit (Pet. 6a-30a) is reported at 292 F. 2d 824. The opinion of the District Court for the Eastern District of Pennsylvania (Pet. 1a-3a) is not reported.

Jurisdiction

The judgment of the Court of Appeals (Pet. 31a) was entered on July 5, 1961. The order of the Court of Appeals denying a petition for rehearing (Pet. 32a) was entered

on September 19, 1961. The petition for a writ of certiorari was filed on October 25, 1961. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

Question Presented

Whether the Court of Appeals properly held, in affirming an order of the District Court, that plaintiff shareholders, the respondents herein, cannot be required to post security for costs, including counsel fees, in a non-diversity federal action (diversity of citizenship not being available or alleged as a basis for jurisdiction) invoking federal jurisdiction exclusively under the Securities Exchange Act of 1934 (a federal statute giving the federal district courts exclusive jurisdiction of all such actions) against the officers and directors of their corporation and other defendants (all of whom are petitioners herein), plaintiffs suing derivatively on behalf of their corporation, suing in their own right, and bringing a spurious class suit, where the complaint alleges and the plaintiffs claim that the causes of action set forth in the complaint are all based exclusively upon defendants' alleged violations of Section 10(b) of the Securities Exchange Act of 1934, and of Rule 10b-5 (formerly called and sometimes still referred to as Rule X-10B-5) adopted thereunder by the Securities and Exchange Commission, with Section 29(b) of said Act providing a supporting basis for a cause of action by reason of the violations of Rule 10b-5, there being no security requirement provision in Section 10(b), Section 29(b), or Rule 10b-5, although the State of incorporation and the forum State both have statutes providing for such security in stockholder derivative actions.

Statutes and Rule Involved

Section 10(b) of the Securities Exchange Act of 1934, as amended (the "Act"), 15 U.S.C. §§78a, 78j, is set forth at page 6 of the petition.

Rule 10b-5 (17 Code of Federal Regulations 240.10b-5) was adopted in 1942 by the Securities and Exchange Commission, under its original designation of Rule X-10B-5, pursuant to the authority of Sections 10(b) and 23(a) of the Act, 15 U.S.C. §§78j, 78w. Rule 10b-5, which is set forth in the opinion of the Court of Appeals (Pet. 8a-9a), provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security."

Section 27 of the Securities Exchange Act of 1934 (15 U.S.C. §78aa) provides:

> "The district courts of the United States, the United States District Court for the District of Columbia, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have *exclusive jurisdiction* of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the

rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this title or rules and regulations thereunder, or to enjoin any violation of such title or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. . . ." (Emphasis added.)

Section 29(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78cc(b)) provides:

"Every contract made in violation of any provision of this title or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule or regulation: *Provided*, (A) That no contract shall be void by reason of this subsection because of any violation of any rule or regulation prescribed pursuant to paragraph (2) or (3) of subsection (c) of section 15 of this title, and (B) that no contract shall be deemed to be void by reason of this sub-

> section in any action maintained in reliance upon this subsection, by any person to or for whom any broker or dealer sells, or from or for whom any broker or dealer purchases, a security in violation of any rule or regulation prescribed pursuant to paragraph (1) of subsection (c) of section 15 of this title, unless such action is brought within one year after the discovery that such sale or purchase involves such violation and within three years after such violation."

The New Jersey statute (14 N.J. Stat. Ann. §3-15), upon which petitioners rely, is set forth in full in the opinion of the Court of Appeals at Pet. 17a. The Pennsylvania statute (12 Purd. Pa. Stat. §1322), upon which petitioners rely, is set forth in full in the opinion of the District Court at Pet. 2a-3a.

Statement of the Case

Petitioners seek a review by this Court of the judgment (Pet. 31a) of the Court of Appeals for the Third Circuit (Biggs, Chief Judge, and Staley and Hastie, Circuit Judges) affirming the order (Pet. 5a) of Circuit Judge Goodrich, sitting specially in the District Court for the Eastern District of Pennsylvania, denying the motions of petitioners to require respondents to post security for costs, including counsel fees. Petitioners filed a petition for rehearing with the Court of Appeals which was denied (Pet. 32a).

The opinion of the Court of Appeals, written by Chief Judge Biggs, is set forth at pages 6a-30a of the petition. Judge Goodrich's opinion in the District Court is set forth at pages 1a-3a of the petition.

Respondents brought this action in the United States District Court for the Eastern District of Pennsylvania exclusively under and pursuant to Sections 10(b), 27 and 29(b) of the Securities Exchange Act of 1934 (15 U.S.C. §§78a, 78j, 78aa, 78cc), a federal statute, and Rule 10b-5

(Rule X-10B-5)[1] adopted by the Securities and Exchange Commission ("SEC"), a federal agency, under the authority of Sections 10(b) and 23(a) of the Act (App. 7a).[2] The causes of action set forth in the complaint (App. 7a-40a) are all based upon the violation of Rule 10b-5 by petitioners (with Section 29(b) providing a supporting basis for a cause of action by reason of the violations of Rule 10b-5).

The federal jurisdiction of the District Court was invoked in this action solely under and by reason of Section 27 of the Securities Exchange Act of 1934 (15 U.S.C. §78aa), which grants the federal district courts "exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder" (App. 7a). *No diversity of citizenship was alleged and complete diversity between respondents and petitioners (plaintiffs and defendants) does not exist.*

Respondents filed the complaint (App. 7a-38a) in District Court on December 19, 1959, and a supplement to complaint (App. 1b-6b) on January 18, 1960. Plaintiffs are small stockholders of petitioner Borne Chemical Company, Inc. ("Borne"), a New Jersey corporation having its principal office in New Jersey, jointly owning 100 shares of its capital stock at the time of the transactions

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[1] When adopted by the SEC in 1942 this rule was designated as Rule X-10B-5. Though now renamed Rule 10b-5, it is still widely referred to as Rule X-10B-5. Until recently most courts and writers have used the designation Rule X-10B-5. The complaint herein, while noting its new name (App. 8a), referred to this rule as Rule X-10B-5. So did the opinion and order of the District Court (Pet. 1a-5a). The opinion of the Court of Appeals (Pet. 6a-30a) referred to it as Rule 10b-5. This is the designation used generally in this brief. The petition for writ of certiorari uses the designation Rule X-10B-5. The full text of this rule is set forth *supra* at page 3.

[2] "App." refers to the printed appendices filed by the appellants and appellees in the Court of Appeals, which appendices are part of the record filed in this Court.

complained of and at all times since (App. 8a-9a). The defendants and petitioners herein are Borne, its officers and directors, and The CEM Securities Corporation ("CEM"), a Delaware corporation (App. 10a-11a). The complaint alleged that plaintiffs bring this action "on behalf of themselves in their individual capacities as stockholders" of Borne; as a "spurious class suit" on behalf of themselves and all other stockholders of Borne similarly situated, numbering more than 1,000; and "on behalf of themselves and all other stockholders similarly situated to enforce their derivative or secondary rights as stockholders" of Borne (App. 9a-10a).

It is alleged that the defendants violated Rule 10b-5 in connection with the sale by Borne to CEM of 10,000 shares of Borne's authorized but unissued capital stock pursuant to an agreement made November 25, 1959. The complaint alleges that the defendant officers and directors of Borne (including its two majority and controlling stockholders), together with defendant CEM and its controlling stockholder as participants and co-conspirators (App. 27a), used a "manipulative or deceptive device or contrivance" within the meaning of Section 10(b) of the Act (App. 21a), employed a device, scheme or artifice to defraud, and engaged in acts, practices or a course of business which operated and operates or would operate as a fraud or deceit upon Borne Chemical Company, Inc., the plaintiffs and other stockholders of Borne, and made untrue statements of material facts or omitted to state material facts necessary to make statements made (in the light of the circumstances under which they were made) not misleading, all in violation of the specific provisions of Rule 10b-5, in connection with said sale of 10,000 shares.

The complaint alleges that the defendants caused Borne to sell the 10,000 shares to CEM at an improperly low price; that the price was low at the time it was fixed and "extremely low in the light of subsequent market prices" (App. 20a, 24a-25a); that the market prices of

and the volume of trading in Borne's stock (which is traded but not listed on the American Stock Excharge) sharply increased immediately after the agreement to sell to CEM was entered into on November 25, 1959, continuing to and beyond the filing of the complaint on December 19, 1959 (App. 16a, 20a-22a; 4b); that by virtue of this substantial increase in market price from the date of the CEM agreement to the date, almost a month later, when the shares were finally issued to CEM and the deal was consummated, CEM received stock having a market value then of $350,000 or more in return for a purchase price of only $220,000, thus depriving Borne (and its stockholders, including respondents) of potential corporate funds amounting to $130,000 or more (App. 22a); and that the increased volume of trading of Borne stock on the American Stock Exchange, and the substantial increase in price thereof, "are attributable, at least in substantial part, to trading and other activities by defendants and other corporate insiders, directly or indirectly, which activities constitute 'manipulative or deceptive devices or contrivances' and unlawful conduct" within the meaning of Section 10(b) of the Act and Rule 10b-5 (App. 21a).

It is further alleged that Borne Chemical Company, Inc. "and the present officers and directors of the Company are under the domination and control of defendants Betner, Less and McManus who are substantial stockholders and directors of Company and who are the principal persons responsible for the transaction, acts and course of conduct complained of herein" (App. 9a); and that, at all times relevant hereto, Betner and Less, between them, owned or controlled a majority of all of Borne's outstanding shares of stock (App. 11a). Betner is President of Borne, Less is Chairman of the Board, and McManus is an officer, director and a controlling stockholder of CEM (App. 9a, 11a-12a). McManus was made a director of Borne between the date of the CEM agreement and the

date the sale of stock was consummated (App. 11a). It is alleged that, as a result of the sharp increase in market price of Borne stock beginning immediately after the CEM agreement was entered into on November 25, 1959, within a period of three weeks thereafter, by the time respondents had instituted this suit and before the sale of stock to CEM was consummated, the blocks of shares of Borne stock owned or controlled by petitioners Betner and Less had each appreciated in market value by more than $3,000,000 (or $6,000,000 in aggregate), and the block of shares of Borne stock owned by petitioners CEM and or McManus on November 25, 1959 (excluding the 10,000 shares in question) had appreciated in market value by approximately $400,000 (App. 21a-22a).

It is alleged that the acts, transactions and other violations of Rule 10b-5 complained of were schemed and done in furtherance of a conspiracy among the officers and directors of Borne, the majority stockholders of Borne, CEM, and CEM's controlling stockholders, all of whom are petitioners herein, which was intended to defraud and, in fact, operated as a fraud upon Borne, upon the respondents and upon other stockholders similarly situated, all within the meaning of Rule 10b-5 and in violation thereof (App. 9a, 27a-28a, 30a).

Contrary to the erroneous statements in the petition that respondents "claimed that petitioners violated their state-imposed fiduciary duties" (Pet. 7) and "state-created" fiduciary obligations (Pet. 2), the complaint alleged that the defendant officers, directors and controlling stockholders violated Rule 10b-5 in breaching a number of important fiduciary obligations to Borne Chemical Company, Inc. and/or its stockholders (Pet. 23a-27a, 28a-34a), such fiduciary obligations arising under Rule 10b-5 the broad anti-fraud objectives of which require corporate insiders to observe high fiduciary standards toward their corporation and its stockholders and require the "applica-

tion of well known and well established equitable principles governing fiduciary relationships." [3]

Thus, among other violations of Rule 10b-5 through the breach of fiduciary obligations arising thereunder, the complaint alleged a violation of Rule 10b-5 in that defendants breached their fiduciary obligation to make full and timely disclosure to plaintiffs and other stockholders of all material facts pertaining to the proposed sale of 10,000 shares to CEM, the proposed amendment of the by-laws terminating preemptive rights, and other matters complained of in this action (App. 26a). In this connection, the complaint alleged in detail the respects in which petitioners breached their fiduciary obligations (all in violation of the anti-fraud provisions of Rule 10b-5) to make full and honest disclosure of all material and relevant facts in the proxy material and proxy statement mailed to respondents and other stockholders in soliciting their proxies for a special meeting of stockholders to vote for the elimination of preemptive rights, and to refrain from making such proxy material and proxy statement untruthful or misleading whether through statements or omissions made therein (App. 33a-34a). The affirmative vote of two-thirds of the stockholders to amend the by-laws to terminate preemptive rights, and the defendant management's solicitation of proxies in connection therewith, each constituted an integral part of the entire transaction complained of, and each must be construed as being "in connection with the purchase or sale" of securities within the meaning of Rule 10b-5 (App. 35a). Consummation of the transaction depended upon such affirmative vote of stockholders and upon the success of defendants' proxy solicitation. It is alleged that the petitioners fraudulently deprived the respondents and all other stockholders of their preemptive rights with respect to the 10,000 shares sold to CEM, a

[3] *Kardon v. National Gypsum Co.*, 73 F. Supp. 798, 803 (E.D. Pa. 1947).

substantial stockholder of Borne, in a preferred sale (App. 28a-30a).

Plaintiffs seek only equitable relief in this action (App. 36a-38a; 5b). The complaint originally sought to enjoin the holding of the special meeting of stockholders called to vote on the termination of preemptive rights and to enjoin the consummation of the sale to CEM, but this is now moot. The relief still sought involves the rescission of the agreement of November 25, 1959 with CEM and the transaction in which Borne issued 10,000 shares of stock to CEM, to return said shares to Borne. The prayer requests that this agreement be adjudged void by virtue of Section 29(b) of the Securities Exchange Act of 1934; that the defendants be found to have violated Rule 10b-5 and Section 10(b) of the Act; that defendants be enjoined from continuing to violate the same; and that the defendants be directed to make a full and complete disclosure. Plaintiffs also request that defendants be directed to render an accounting and to make appropriate and full reimbursement and payment to Borne, the plaintiffs and other stockholders for all loss, injury and damage suffered by the latter and for all moneys, property, proceeds and emoluments received by defendants by reason of the violations of Rule 10b-5 complained of herein.

The defendants did not file answers to the complaint but moved to require plaintiffs to post security for expenses including reasonable attorneys' fees. The defendants based their motion for security on a Pennsylvania statute (12 Purd. Pa. Stat. §1322), on Section 11(e) of the Securities Act of 1933, as amended (15 U.S.C. §77(k)(e)), and on "equitable principles and rules" (App. 39a-40a).

Circuit Judge Goodrich, sitting specially in District Court, denied defendants' motions for security on condition that the plaintiffs file a statement, in accordance with what plaintiffs had previously stated, limiting their claims to causes of action arising under Rule 10b-5 and Section 29(b) (Pet. 1a-5a). Plaintiffs complied therewith and con-

firmed the clear intent of the complaint by filing a stipulation (Pet. 4a) in the District Court stating that the causes of action claimed and set forth in the complaint "are all based upon violations of Rule X-10B-5 by the defendants (with Section 29(b) of the Securities Exchange Act of 1934 providing a supporting basis for a cause of action by reason of the violations of Rule X-10B-5)", and further stating that plaintiffs "claim no other cause of action in this litigation against these defendants".

Petitioners err in stating (Pet. 8) that "The District Court denied petitioners' motion on the ground that where the pleadings claim that the corporate cause of action was based upon violation of a federal *criminal* statute, the State statute with respect to security for costs in a derivative action cannot be applied" (Emphasis added). The District Court made no such reference to a "criminal" statute.

On appeal taken by petitioners, the United States Court of Appeals affirmed the order of the District Court denying petitioners' motions for security (Pet. 6a-31a).

Argument

The petition presents a narrow issue arising in this private litigation under the Securities Exchange Act of 1934. No matter how much the petition strains to show that the decision below conflicts with decisions of this Court and with a recent decision of the Seventh Circuit, no matter how much the petition labors to give "public importance" to the issue presented, no matter how many times the petition says the decision below is wrong, a reading of the petition and of the magnificent, well-reasoned opinion of the Court of Appeals makes it abundantly clear that there is no conflict, that the decision below is perfectly correct and in accordance with all existing decisions and the best academic thought on the issue involved, and that there is certainly nothing here to warrant review by this Court on certiorari.

1. To the best of our knowledge, all federal courts which have ever considered the question have held uniformly that it is improper to grant security for expenses in a Rule 10b-5 or Rule X-10B-5 action. The Court of Appeals for the Second and Third Circuits, which have given careful thought to the question, are in complete agreement. No decision of this Court, of any circuit, of any district court, has held to the contrary. There is no conflict, there is no semblance of any conflict on the specific point involved or on any other point of any significance here. The decision of the court below is in accordance with the statement of the law on the subject by Professor Louis Loss of Harvard Law School, cited by the Court of Appeals (Pet. 29a-30a) and by Judge Goodrich in the District Court who referred to him as "the foremost authority in the field" (Pet. 2a).

2. The narrow question presented here is, in the language of the Court of Appeals below (Pet. 7a-8a), "whether a shareholder who brings a derivative suit to enforce a corporate cause of action arising under Section 10(b), as implemented by Securities and Exchange Commission Rule 10b-5, and Section 29(b) of the Securities Exchange Act of 1934, may be required to post security for costs, including reasonable attorney's fees." The Court of Appeals answered this question in the negative in accord with the same holding of the Court of Appeals for the Second Circuit in *Fischman v. Raytheon Manufacturing Co.*, 188 F.2d 783, 788-89 (1951), and in accord with the carefully considered opinion of the Second Circuit in *Fielding v. Allen*, 181 F.2d 163 (2d Cir. 1950), *cert. denied* sub nom. *Ogden Corp. v. Fielding*, 340 U.S. 817 (1950), where "the Second Circuit had before it a question almost identical to that with which we are presently concerned" (Pet. 20a). The *Fielding* opinion was written by Circuit Judge Swan for the Court consisting of himself, Chief Judge Learned Hand and Circuit Judge Chase. The *Fischman* opinion was written by Circuit Judge Frank speaking for himself, and Circuit Judges Swan and Chase.

3. The opinion below (Pet. 6a-30a) of the Court of Appeals for the Third Circuit is a classic opinion of persuasive reasoning, clarity and judicial decisiveness. It was written by Chief Judge Biggs for the Court consisting of himself and Circuit Judges Staley and Hastie. Chief Judge Biggs also wrote the opinion for the Third Circuit in *Cohen v. Beneficial Industrial Loan Corp.*, 170 F.2d 44 (3rd Cir., 1948), affirmed by this Court in 337 U.S. 541 (1949), where the New Jersey security-for-costs statute was applied and security was required in a diversity stockholder's derivative action in which the federal court had jurisdiction, as this Court emphasized, "only because the parties are of diverse citizenship." 337 U.S. 541, 543. Judge Biggs, in his opinion below, easily distinguished the *Cohen* decision as being "not in point" in this non-diversity action (Pet. 15a).

4. Though able judges may err, is it not of some significance that the decision below was that of Judges Biggs, Staley and Hastie, that this same decision in the District Court was first reached by Circuit Judge Goodrich sitting there specially, and that this decision is in accordance with the thinking of Chief Judge Learned Hand and Circuit Judges Swan and Chase in the *Fielding* case and of Circuit Judges Frank, Swan and Chase in the *Fischman* case?

5. Even if this Court were otherwise inclined to grant certiorari because of the question raised under Section 10(b) and Rule 10b-5, it is highly doubtful that it would want to grant certiorari in a case such as this where respondents are suing not only under that statutory provision and rule but also under Section 29(b) of the Securities Exchange Act of 1934, and in a case such as this which is not only a stockholders' derivative action but also an action in which the respondents are suing in their own individual right and in a representative capacity on behalf of their class, all other stockholders similarly situated. Even if this Court were to disagree with the court below and were to

conclude that a security-for-expenses provision should be implied from Section 10(b) and Rule 10b-5 along with the private right of action which has been implied in connection therewith, not even the petitioners contend that security for expenses can be required in an action under Section 29(b), which grants an express right of action (Pet. 30a) and which specifically includes a statute of limitations but not a security provision. See supra pages 4-5. Moreover, it is clear that there is no basis on which and no contention that respondents could be required to post any security for expenses in connection with their suit herein as stockholders in their individual capacities and own right and in their representative class action. The complaint alleges direct causes of action on the same facts which the respondents and their class have under Section 10(b), Rule 10b-5 and Section 29(b) against the petitioners wholly apart from the causes of action which basically belong to Borne Chemical Company, Inc. and which respondents are asserting as secondary rights in the derivative part of this action. *Thus, even if this Court were to reverse the court below and were to require the respondents to post security in connection with the derivative phase of this suit, the respondents could, if they chose, then eliminate the derivative aspects of their suit and proceed with this action on the same allegations asserting their own extensive causes of action and those of all other stockholders similarly situated arising out of the same facts all without any need to post security.* Will this Court grant certiorari on the limited issue presented here under such circumstances where its decision is likely to have such a limited effect upon the course of this private litigation?

6. The court below rejected the possibility that a security provision could be implied in Section 10(b) and Rule 10b-5 on analogy to and borrowing from those sections of the Securities Exchange Act of 1934 and of the Securities Act of 1933 which do provide for the imposition of security for expenses (Pet. 27a-30a). Though petitioners

take some slight exception to this ruling (Pet. 16-17), their principal contention is that the New Jersey or Pennsylvania security-for-expenses statute should be applied here. In this connection it is both interesting and noteworthy that petitioners have had some difficulty in this proceeding in trying to determine whether they should rely upon the statute of Pennsylvania, the forum, or of New Jersey, the State of incorporation and principal place of business. In the District Court, as their motions (App. 39a-40a) and the District Court's opinion (Pet. 1a-3a) indicate, petitioners relied only upon the Pennsylvania statute. In the Court of Appeals the petitioners relied almost completely upon the Pennsylvania statute mentioning only in a footnote that "it is arguable that since New Jersey law determines whether directors violated their fiduciary duty in not bringing the suit, perhaps the New Jersey statute on security for costs, including counsel fees, is the applicable statute" (Brief for Appellants, p. 18, n. 5.). In their petition for certiorari it is the New Jersey statute which the petitioners emphasize, even though their motions for security did not even mention the New Jersey statute. In this connection it will be noted that the Court of Appeals summarily dismissed the Pennsylvania statute as "clearly inapplicable" (Pet. 15a) but stated that "the question whether the New Jersey security-for-expenses statute applies poses a subtler problem" (Pet. 17a), concluding that the New Jersey statute is also inapplicable. In any event, neither the Pennsylvania nor New Jersey security-for-expenses statute is applicable in this action for the reasons articulated by the court below and noted *infra*. Just as the Second Circuit held in the leading case of *Fielding v. Allen*, 181 F.2d 163 (2d Cir., 1950), *cert. denied* sub nom. *Ogden Corp. v. Fielding*, 340 U.S. 817 (1950), where the question involved was "almost identical to that with which we are presently concerned" (Pet. 20a), so here the cause of action alleged by respondents on behalf of the corporation is "federally-based", the stockholder's right to maintain a derivative action on a corporate right federal in nature is "federally

conferred", the stockholder's right is "itself federal in nature" and it is therefore "not subject to special requirements for cognate actions under the state law", particularly the New Jersey or Pennsylvania security-for-costs statute.

7. In addition to the fact that the stockholders' derivative suit here is *not* a diversity action where a state security-for-expenses statute would be applied under the rule of the *Cohen* case, it should be noted that this is an action under Section 27 of the Securities Exchange Act of 1934 which gives the federal district courts *exclusive* jurisdiction and not merely concurrent jurisdiction over this action. Certainly this is so much the more reason for disregarding the state security-for-expenses statutes, which only a small minority of the states have enacted and which vary in their provisions, in favor of a uniform federal policy on the subject in these Rule 10b-5 cases over which federal courts have exclusive jurisdiction.

8. The petition for certiorari emphasizes repeatedly that Section 10(b) of the Securities Exchange Act is a "*criminal*" statute. Whatever connotation this is intended to have, we think it more proper merely to note that Section 10(b) makes certain acts, practices and conduct "unlawful"; and that a private right of action, though not expressly given by Section 10(b) or Rule 10b-5, has been implied thereunder on the basis of the *Kardon* doctrine.[1] Whether or not the *Kardon* doctrine is correct and whether or not the respondents have, or have properly alleged, private causes of action under Rule 10b-5 are not at issue at this time.

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[1] *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

I. The Decision Below Is Clearly Correct

The magnificent opinion written by Chief Judge Biggs in the court below (Pet. 7a-30a) reflects a very careful consideration by the Court of Appeals for the Third Circuit of all arguments presented by the petitioners and of other questions which the Court of Appeals considered.

First, the Court pointed out that "the derivative suit has been the principal defense of the minority shareholder against abuses by the majority"; that equity has provided shareholders with the device of a derivative suit and has also itself imposed many limitations on the use of this device to protect against certain dangers of abuse inherent in its use (Pet. 10a-11a). Despite these safeguards imposed by equity itself, a small minority of the states have seen fit to enact security for expenses statutes applicable to stockholder derivative suits, but these statutes are not uniform in their provisions (Pet. 11a-13a). "From their inception security for expenses statutes have been the subject of heated controversy" (Pet. 13a). But "there is one proposition about which there is no controversy. A security for expenses statute poses a very serious obstacle to those shareholders to whom it applies who desire to maintain derivative suits" (Pet. 15a).

In dismissing petitioners' argument that the Pennsylvania security statute is applicable here, the Court of Appeals was obviously correct in stating as follows (Pet. 15a): "The Pennsylvania security for costs statute is clearly inapplicable even though this action was commenced in a federal court sitting in that State. In *Erie R. R. v. Tompkins*, 304 U.S. 64 (1938), it was held that the substantive rules of law of the state in which a federal court sits are the rules of decision applicable in diversity actions brought in that court. That security for expenses statutes are 'substantive' law as that term was used in the *Erie* decision was decided in *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541 (1949). In the present case, however, we are not concerned with a cause of action in which federal juris-

diction depends on diversity of citizenship, but with a case arising under a federal statute which itself confers jurisdiction upon the federal district courts. See Section 27(a) of the Act, 15 U.S.C.A. §78aa. The *Erie* doctrine and the holding in the *Cohen* case are, therefore, not in point. See *Rothenberg v. H. Rothstein & Sons*, 183 F. 2d 524, 528 (3 Cir. 1950)."

The Court below properly rejected petitioners' argument that the Pennsylvania statute should be applied in the present case (where there is no provision in Section 10(b), Rule 10b-5 or Section 29(b) authorizing a court to require security) on analogy to the doctrine whereby local statutes of limitations are applied in cases arising under federal statutes which contain no provisions for limitations of action. The Court concluded that "the reasoning underlying that doctrine renders it inapposite in the case of a security for expenses statute" (Pet. 16a). True enough, local limitation statutes are applied in actions at law under federal statutes where Congress is silent on the subject because these statutes of limitations embody a "cardinal principle of modern law" to which, it should be presumed, Congress intended to subject rights of action which it has created (Pet. 16a). There is a "presumed congressional intent to have courts judicially imply a limitation provision" and this presumption "is justified by the fundamental and universal nature of the concept of limitation and the improbability of Congress having intended to create a right not subject to a limitation period" (Pet. 16a-17a).

However, as Judge Biggs stated very persuasively (Pet. 17a), "In the present case we are not dealing with congressional silence on limitations but silence on security for expenses. Unlike statutes of limitations, security statutes do not embody traditional principles of law which are universally accepted. There is sharp dispute as to their desirability and efficacy. Moreover, only a minority of our states have enacted such statutes. Under these cir-

cumstances a presumption that Congress intended that courts should imply a security requirement from a statute, granting an express or an implied private right of action seems unjustified. *Congress cannot be presumed to have authorized the courts to engraft a unique and controversial limitation upon a statutory right through its silence on the subject of that limitation.*" (Emphasis added.)

With respect to the applicability here of the New Jersey security for expenses statute, the court below carefully considered the "subtler problem" posed by the fact that New Jersey is the State of incorporation of petitioner Borne and the place of its principal office (Pet. 17a-18a). "As such New Jersey has a clear interest in the relationships between the stockholders and the management of the corporation" (Pet. 18a). When New Jersey enacted its statute, it made "a far-reaching and fundamental alteration of existing stockholders-management relationships" and "the right of a shareholder of a New Jersey corporation to bring a derivative suit was severely limited" (Pet. 18a). The question is: "Should this limitation be adhered to by a federal court when the corporate right that the plaintiff seeks to enforce derivatively arises under federal law?" (Pet. 18a).

In answering this question in the negative, the Court of Appeals stated that it did "not believe that Sections 10(b) and 29(b) of the Securities Exchange Act should be construed as being superimposed upon the stockholder-management relationship defined by state security for expenses statutes, since the federal provisions are a part of a statutory scheme which had as its purpose the creation of a new federal law of management-stockholder relations and which, therefore, may not be subordinated to limitations such as security for expenses statutes, reflecting state policy in the same area. It is true that federal law often depends upon state-created legal relationships. Admittedly, where, precedent to the enforcement of a federal right, a question arises on the resolution of which Congress has

been silent, state law will be controlling in many instances. But state law will only control where that law will not cut across the federal interests receiving expression in the federal right sought to be enforced. . . . In the present case we are construing two sections of the Securities Exchange Act of 1934. That Act deals with the protection of investors, primarily stockholders. It creates many managerial duties and liabilities unknown to the common law. It expresses federal interest in management-stockholder relationships which theretofore had been almost exclusively the concern of the states. Section 10(b) imposes broad fiduciary duties on management vis-a-vis the corporation and its individual stockholders. As implemented by Rule 10b-5 and Section 29(b), Section 10(b) provides stockholders with a potent weapon for enforcement of many fiduciary duties. It can be said fairly that the Exchange Act, of which Sections 10(b) and 29(b) are parts, constitutes far reaching federal substantive corporation law. . . ." (Pet. 23a-24a).

Judge Biggs pointed out that "state security for expenses statutes are more than procedural modifications. They are, rather, fundamental regulations of the management-shareholder relationship. As such they cut across a similar federal interest embodied in the Securities Acts. If held to be applicable in actions under Section 10(b) they would limit severely the scope of that section in an area comprehended by the statutory scheme. Where a unique and controversial state doctrine alters relationships that are the principal concern of a federal statute that doctrine will not be applied to limit rights arising under the federal statute. Thus state interest in the present suit must be subordinated to the federal policy occupying the same field. . . ." (Pet. 24a-25a).

Judge Biggs quoted at length and with approval from the opinion of the Court of Appeals for the Second Circuit in *Fielding v. Allen*, 181 F.2d 163, *cert. denied* sub nom. *Ogden Corp. v. Fielding*, 340 U.S. 817 (1950) where it

was held that "the stockholder's right to maintain a derivative action on a corporate right federal in nature is federally conferred" by federal equity law and that in non-diversity cases this federal equity right of a stockholder should be available without reference to the peculiar requirements of local law (Pet. 19a-22a). In the *Fielding* case, the Second Circuit refused to apply the New York security for expenses statute to require the plaintiffs in a stockholder derivative action under the federal Transportation Act of 1920 to post security for expenses. The Court below stated:

"We agree with the result reached by the Second Circuit in the *Fielding* case and with its reasoning that in a case such as that at bar the policy of uniformity within the federal system is stronger than any policy of conformity with local rules. As we have pointed out only a minority of states have adopted security statutes and the statutes differ from one another. There is much to be said for the argument that a federal right, uniform in its nature throughout the nation, should be uniformly enforceable pursuant to federal standards. That Congress intended uniform enforcement of rights arising under The Securities Exchange Act of 1934 is indicated strongly by the fact that it gave exclusive jurisdiction to the United States courts of any suit brought to enforce the duties or liabilities created by the Act. See Section 27 of the Act, 15 U.S.C.A. §78aa." (Pet. 22a).

The Court of Appeals rejected the suggestion by petitioners that security for expenses may be required under "general federal equity law" (Pet. 25a-26a). The Court of Appeals also rejected the contention of petitioners that, since a private right of action is implied rather than explicitly granted by Section 10(b) and Rule 10b-5, a security for expenses limitation should be implied along with the implied private remedy because the Securities Exchange Act does contain security provisions in certain other sections. The Court stated: "This argument is, of course, ten-

able only where the statute evinces a clear policy in favor of security for expenses limitations. Even then, we believe, there would be a serious question whether a court, in the proper exercise of its judicial function, could carry the traditional tort doctrine of implication of private remedies to such a length. With respect to Section 10(b) and Rule 10b-5, however, we do not have to deal with the extent to which we can impose limitations on private rights of action implied from statutes because we have concluded that the Securities Acts do not evince a sufficiently clear or uniform policy in favor of security for expenses provisions to justify the imposition of such a limitation on the private right of action which has been implied from Section 10(b)." (Pet. 27a-28a).

The Court below reviewed the different security provisions in the Securities Act of 1933 and the Securities Exchange Act of 1934 (Pet. 28a-29a); noted that these provisions varied; and pointed out that only Section 9(e) and Section 18(a) of the Securities Exchange Act of 1934 (15 U.S.C. §§78i, 78r) contain security for expenses provisions in connection with private actions under those sections. Even there it is discretionary and not mandatory for the court to require the posting of security. On the other hand, as the Court of Appeals emphasized, "Section 16(b) of the Exchange Act, 15 U.S.C.A. §78p, which grants rights of action to shareholders injured by 'insider-trading', has no security for expenses requirement. Similarly, Section 29(b) of the Act, pursuant to which this action is brought in part, does not contain a security requirement." (Pet. 29a). Accordingly, the Court below properly concluded that "It is apparent that the Acts do not manifest sufficiently clear or uniform policy favoring security for expenses to allow us to imply such a limitation from Section 10(b). Were we to attempt to do so we would have to discover some reason for following the course Congress took with respect to the Securities Act and Sections 9(e) and 18(a) of the Exchange Act rather than that exemplified by Sec-

tion 16(b). But there seems no rational basis for concluding that the right of action implied from Section 10(b) bears a greater similarity to the sections limited by security requirements than it does to Section 16(b) which is unencumbered by that requirement. Indeed, a persuasive argument could be made that the plaintiffs' complaint in the present case, alleging as it does fraudulent dealings by insiders to the detriment of stockholders, sounds as much in Section 16(b) as in any other liability section contained in the Acts. Moreover, even if we decided against the analogy to 16(b), we would be faced with the impossibility of making a rational choice between the provision contained in Section 11(e) on the one hand and Sections 9(e) and 18(a) on the other. For these reasons we decline to imply a security for expenses requirement from Section 10(b) or Rule 10b-5." (Pet. 29a-30a).

II. The Decision Below Does Not Conflict With Any Decisions of This Court or With Any Other Circuit Court Decisions.

There is obviously no merit to petitioners' contention (Pet. 17) that the decision of the Court below is in "direct conflict" with the recent decision of the Court of Appeals for the Seventh Circuit in *Bankers Life and Casualty Co. v. Bellanca Corporation*, 288 F.2d 784 (7th Cir., 1961), *cert. denied* —— U.S. —— (Oct. 9, 1961). There is not the slightest conflict here. In the *Bellanca* case the Seventh Circuit held that Section 29(b) of the Securities Exchange Act only voided the contract rights of the party who was in violation of the Act and did not relieve the party who was not in violation from paying for consideration which the non-violator had actually received from the violator. Since Section 29(b) was not intended to give the non-violator this particular relief, the rights of the non-violator in this respect are to be measured by the law of the state involved. We fail to see the relevance of the *Bellanca* case. And we

might note, there was not a word in the *Bellanca* opinion that warranted the assertion in the petition (17) that the court held there that federal courts should "not attempt to fashion a uniform federal rule". But this inaccuracy in the petition is nothing compared with petitioners' *fantastic* statement on the same page of the petition that "The court below has held that in dealing with the Securities Exchange Act, a federal court fashions its own federal common law and rejects the law of the state of incorporation and the forum in determining those parts of the cause of action which are not expressly or impliedly spelled out in such federal statute"! (Pet. 17)

Petitioners do not allege that there is any direct conflict between the decision below and any decision of this Court. Indeed, there has been no decision of this Court on the question raised in this petition or on any related Rule 10b-5 matter. However, petitioners do contend that "The decision below conflicts with the applicable decisions of this Court dealing with the law to be applied to determine corporate shareholders' rights inter sese and remedies where the federal statute is absolutely silent on the subject" (Pet. 10). A bare reading of this portion of the petition (Pet. 10-17) and, of course, a reading of the decisions of this Court there cited, makes it very clear that petitioners are in error, that there certainly is no direct conflict, that there is no real conflict on the same matter of law or fact, and that there is not even a true inconsistency in dicta or in the general principles utilized.

We must vigorously dispute the statement of petitioners (Pet. 10) that this Court repeatedly has held "in situations similar to the one presented herein" that a federal court should apply State law, even in a suit to enforce express civil provisions of a federal statute where the precise issue is not expressly covered by the federal statute conferring the basic right. In support of this statement the petitioners cite *De Sylva v. Ballentine*, 351 U. S. 570, 580 (1956); *O'Sullivan v. Felix*, 233 U. S. 318 (1914);

and *Campbell v. City of Haverhill*, 155 U. S. 610 (1895). There is clearly no conflict with any of these decisions. They did not involve similar situations. The *De Sylva* and *Campbell* decisions were easily distinguished by the Court below. See Pet. 16a, 23a.

In *De Sylva* the issue was whether illegitimate children were "children" within the meaning of the Copyright Act. This Court looked to state domestic relations law for the answer, reasoning, in part, as follows: "The scope of a federal right is, of course, a federal question, but that does not mean that its content is not to be determined by state, rather than federal law. . . . This is especially true where a statute deals with a familial relationship; there is no federal law of domestic relations, which is primarily a matter of state concern . . ." 351 U. S. 570, 580. However, as the Court below pointed out, "In the present case there is a comprehensive body of federal law with respect to the bringing of derivative suits. Indeed, the derivative suit, and the limitations upon its use, were initially developed in the federal courts. . . . There is, therefore, no compulsion in the present case to adopt state law because it is the only developed body of law pursuant to which this federal right may be enforced." (Pet. 23a).

The *Campbell* and *O'Sullivan* cases, *supra*, were statute of limitations cases. So was *Hooper v. Mountain States Securities Corporation*, 282 F. 2d 195, 205 (5th Cir., 1960), *cert. denied* 5 L. Ed. 2d 693 (1961), upon which petitioners rely (Pet. 11). So also *Tobacco and Allied Stocks v. Transamerica Corp.*, 143 F. Supp. 323 (D. Del. 1956), *affirmed*, 244 F. 2d 902 (3rd Cir., 1957); *Fratt v. Robinson*, 203 F. 2d 627, 634 (9th Cir. 1953); and *Gordon v. Loew's, Inc.*, 247 F. 2d 451, 454 (3rd Cir., 1957)—all cited by petitioners (Pet. 11, n. 8). The opinion of the Court below carefully and persuasively distinguished the present security for expense statute case from the statute of limitation cases. See Pet. 15a-17a and *supra* pages 19-20. We have no conflict of decision here.

What was said by this Court in *Board of County Commissoners v. United States*, 308 U. S. 343 (1939), an Indian treaty case cited by petitioners (Pet. 13), is entirely consistent with the decision of the Court below. See Pet. 19a, 24a.

Though petitioners quote extensively from *Cohen v. Beneficial Industrial Loan Corporation*, 337 U. S. 541 (1949) (Pet. 12-14), we think they concede that the Court below correctly ruled (Pet. 15a) that the holding in the *Cohen* case is "not in point" here because that was a diversity case and this is a non-diversity case. With respect to the language quoted by petitioners from the *Cohen* case, the Court below quoted the same language in discussing and then dismissing the possibility that the security statute of New Jersey, the State of incorporation, might be applicable here. See Pet. 18a. The inapplicability of the *Cohen* decision to non-diversity cases involving federal rights is now well established. *Fielding v. Allen*, 181 F. 2d 163 (2d Cir., 1950), *cert. denied* sub nom. *Ogden Corp. v. Fielding*, 340 U. S. 817 (1950). See *Le Bouef v. Austrian*, 240 F. 2d 546, 551 (4th Cir., 1957); *Breswick & Co. v. Briggs*, 136 F. Supp. 301, 302 (S. D. N. Y. 1955); *Hoover v. Allen*, 180 F. Supp. 263, 267 (S. D. N. Y. 1960). See 3 Loss, *Securities Regulation* (2d ed. 1961) 1839 note 512.

Not only is the decision of the Court below not in conflict with any other decisions, but it is in accord with clearly established law that security for costs cannot be required in a federal court action based upon violation of Section 10(b) of the Securities Exchange Act and of Rule 10b-5 adopted thereunder. ALL FEDERAL COURTS WHICH HAVE EVER CONSIDERED THE QUESTION HAVE HELD, WE BELIEVE, THAT IT IS IMPROPER TO REQUIRE SECURITY FOR COSTS, INCLUDING ATTORNEYS' FEES, IN A RULE 10b-5 OR RULE X-10B-5 ACTION. *Fischman v. Raytheon Manufacturing Company*, 188 F. 2d 783 (2d Cir., 1951); *Stella v. Kaiser*, 81 F. Supp. 807 (S. D. N. Y. 1948); *McManus v.*

The Jessup & Moore Paper Company, et al., Civil Action No. 8015, E. D. Pa. (Order of Judge Bard, entered December 22, 1949, denying, without opinion, motion of defendants to require plaintiffs to give security for defendants' expenses and attorneys' fees); *Acker v. Schulte*, 74 F. Supp. 683, 690 (S. D. N. Y. 1947). See 3 Loss, *Securities Regulation* (2d ed. 1961) 1780, 1836-1842, 1839 note 512, 1842; 6 *Moore's Federal Practice* (1953) 1331 note 40; Note, *Security for Expenses Legislation—Summary, Analysis and Critique*, 52 Col. L. Rev. 267, 275 (1952). The decision of the District Court (Pet. 1a-5a) in the present case is cited with approval by Professor Loss in the new second edition of his treatise, *supra*, at page 1837 notes 503 and 506.

III. Certiorari Should Be Denied

Every interesting question of law has some "public importance", but this certainly is not enough to warrant review by this Court on certiorari. The point involved in this particular private law suit is a rather narrow one. Defendants have made much of it and, as a consequence, it has received the careful consideration and decision of the District Court and the Court of Appeals for the Third Circuit. What they have said in their opinions has been limited to the very limited question raised. But petitioners see great "public importance" in all this (Pet. 18-19). They generalize on the decision below. They see sinister consequences in it. They cry an alarm for certiorari.

It is ironical how petitioners' motions for security for expenses have delayed this proceeding—including all discovery—for almost two years. Respondents commenced this action on December 19, 1959, alleging fraudulent conduct on the part of the corporate insiders and seeking full equitable relief including discovery. On February 9, 1960, some of the petitioners filed motions for security for costs including counsel fees together with motions to dismiss.

The motions to dismiss have been held in abeyance pending the outcome of the motions for security. No answers have been filed to date. On February 9, 1960, the petitioners also notified the respondents of an intention to take their depositions on March 2, 1960. On February 10, 1960, the respondents notified the petitioners that respondents would be available for depositions on the date fixed and that respondents would take the depositions of some of the petitioners and others on March 3, 1960.

Petitioners have shown no interest at any time in proceeding with the depositions of respondents. Moreover, petitioners sought and secured from the District Court a protective order directing the plaintiff respondents to delay taking depositions "until after the motion for posting security is determined." As a result, respondents have not been able to secure any discovery in this action up to the present time. Hopefully, certiorari will be denied and plaintiffs will be able to proceed—after almost two years.

The purpose of seeking security for expenses is to secure a bond for such expenses *before* the corporation is compelled to spend very much in counsel fees and other litigation expenses. In this case, however, the able attorneys for petitioners have devoted already a large amount of time and effort (presumably at substantial expense to petitioners) in seeking security for expenses, in appealing an adverse decision thereon, and in seeking review thereof on certiorari.

Conclusion

For the reasons stated above, it is respectfully submitted that the petition for a writ of certiorari should be denied.

Respectfully submitted,

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November 22, 1961